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SUBJECT: SOUTH AFRICAN RESERVE BANK CUTS INTEREST RATE BY ONE PERCENTAGE POINT

¶1. (U) Summary. The South African Reserve Bank's Monetary Policy Committee (MPC) has reduced the key policy interest rate, the repo rate, by 100 basis points to 10.5 percent. The rate cut was made possible by declining domestic inflation, which the MPC expects to fall within the target range of 3-6 percent in the third quarter of ¶2009. Most analysts believe there will be further cuts in 2009. End Summary.

Interest Rate Cut

¶2. (U) The South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) reduced the key policy interest rate, the repo rate, by 100 basis points to 10.5 percent on February 5, 2009. This was the biggest single adjustment since October 2003. It followed a 50-basis-point cut in December that started reversing a series of 50-basis-point rate hikes between June 2006 and June 2008 that lifted the repo rate by 500 basis points. The MPC explained in a public statement that its decision was made in view of the moderating inflation outlook coupled with deteriorating global and domestic economic conditions. The MPC said it "will continue to monitor domestic and global developments in order to decide on the most appropriate monetary policy stance going forward."

Domestic Inflation Developments

¶3. (U) Data released by Statistics South Africa (StatsSA) showed that CPIX inflation (CPI minus mortgage interest) has been moderating consistently since August 2008, when it measured 13.6 percent. CPIX had fallen to 10.3 percent by December 2008, and the MPC expects a further decline in the January data when the reweighting and rebasing of the CPI index implemented by Statistics South Africa comes into effect. Declining international commodity prices should also add downward pressure on inflation.

Domestic Economic Slowdown

¶4. (U) According to the MPC's statement, the domestic economy is "adversely affected by the continuing turbulence in the global economy and continues to show signs of slowing." The composite leading and coincident business cycle indicators of the SARB point to a continuation of this trend. Recently released economic data indicate that prominent sectors such as mining, manufacturing and wholesale and retail trade are in recession.

Inflation Outlook

¶5. (U) The MPC's most recent central inflation forecast showed CPI inflation averaging 7.5 per cent in the first quarter of 2009, thereafter falling within the 3-6 percent inflation target range

during the third quarter of 2009. Inflation is then forecast to increase again and to breach the upper end of the target range in the first quarter of 2010, mainly as a result of technical base effects. Thereafter inflation is expected to return to within the target range and remain there until the end of 2010, when it is expected to average 5.5 per cent.

Risk to Inflation

¶6. (U) The MPC highlighted the volatile exchange rate as the main upside risk to the inflation outlook. The rand is currently trading at levels similar to those that prevailed at the time of the previous MPC meeting in December. The SARB attributed the current Qprevious MPC meeting in December. The SARB attributed the current rand level to a stronger U.S. dollar and risk aversion in international markets. The MPC said the risks to the inflation outlook posed by oil and food prices appear to have subsided. Food prices continue to moderate at the production price level, while the price of oil remains subdued as a result of weakening global growth.

Local Reaction

¶7. (U) Most analysts welcomed the MPC's decision to cut interest rates by more than the usual 50 basis points. SARB Governor Tito Mboweni told reporters that he had suggested slashing rates by 200 basis points, but that other MPC members convinced him otherwise. Analysts said this might indicate that more cuts of similar magnitude were likely this year. A Nedbank economist told Embassy Economic Specialist he expects the SARB to aggressively cut interest in the first half of 2009, followed by more modest easing in the second half.

Comment

¶8. (U) Lower interest rates could not have come at a better time for South Africa. Along with heavy infrastructure spending and a weak rand that will support greater exports and import substitution, lower interest rates will help to prop up demand in a time of economic stress. The combined effect may be enough to keep South Africa from falling into negative growth in 2009.

LA LIME